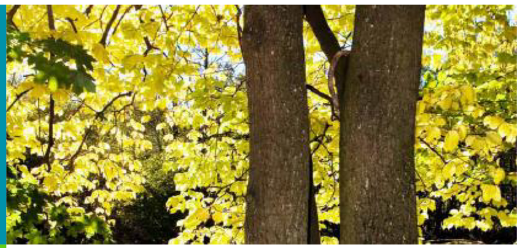
Investment Outlook

Rising optimism inspires hope for bright autumn



INVESTMENT OUTLOOK SUMMARY

SEPTEMBER 2013

Brief world economic outlook

The world economic outlook is improving. Leading indicators in the household and business sectors point to accelerating global growth, risk appetite is increasing, headwinds from fiscal austerity measures will diminish and monetary policy will continue to support growth and financial markets.

World inflation will be persistently low thanks to plenty of spare capacity in OECD countries (developed markets, DM). This will keep wage and salary costs in check, while slower growth in Asia will create downward pressure on commodity and energy prices. Central banks will thus have manoeuvring room to delay key interest rate hikes, which will also facilitate the task of implementing restructuring measures and fiscal consolidation.

Prospects for higher global growth are better today than for a long time. We foresee global growth of above 3 percent this year, 4 percent in 2014 and above 4 percent in 2015. The emerging markets (EM) sphere will remain the fastest growing at nearly 5,5 percent in 2014-2015. Yet the growth gap between EM and DM countries will narrow significantly, with the latter showing a GDP increase of about 2,5 percent next year and nearly 3 percent in 2015.

We are heading into a very interesting period. The three economically biggest regions in the world – the US, Japan and Europe – are approaching stabilization and probably higher growth.

To some extent, the economy is organic. It is about people, their faith in the future, hope and courage. We have seen signs that optimism is beginning to grow.

For a long time, the Japanese economy has been characterized by deflation, which has stifled consumer confidence and capital spending. Recently we have the Japanese acting more optimistically and in our view Japan needs to be re-examined. We also see Europe as a region with genuine potential to be a good investment this autumn. The European Central Bank (ECB) still emphasizes that the euro zone economy needs support, but all indications are that the recession there has ended. Another example is that the US Federal Reserve (Fed) is beginning to talk about reducing its support to the economy. The concept of “tapering” has become the term that describes the American central bank’s planned reduction in its current bond purchases, which it has employed in order to provide liquidity to the market. Removing such support is normal, and in itself a good sign, but once this happens it will have an impact on markets. There are two reasons why the market reacts. One is that investors are worried that the economy will slow without such support. The other is that the capital supply and short-term interest rates are the basis for the entire global financial system. The withdrawal of a source of liquidity is thus another cause for concern.

The amount of liquidity and the level of interest rates affect bond yields, which have recently shown relatively sharp increases. When this happens in the US, it has a major impact on global capital flows. This time was no exception, and emerging markets have seen large outflows. Key interest rates will remain unchanged for a long time to come. The Fed says until 2015, market prices point to 2014 and the future will show which of these is correct.

All this is positive and indicates that during the autumn, the building blocks of normalization will continue to be put in place. However, recoveries after financial crises are lengthy and during this time consuming process the markets will be volatile, but it will also create opportunities.

Themes

Time for a positive view of Europe

The euro zone still has bigger fundamental problems than many other regions in the global economy, so recovery will be marked by some imbalances, risks and uncertainty. Nevertheless, there are signs of brighter prospects and reasons to adopt a more positive view of the region.

There are several factors that will gradually change the outlook for Europe and that favour focusing on Europe as an investment. First, the economy is stabilizing and one important effect of this is that economic growth is spreading to more sectors. A clear example is rising domestic consumer demand, but also increasing capital spending in manufacturing. Second, financially, the picture has improved considerably. A stronger economy is generating more tax revenue; countries are healing on their own. ECB eliminated many of the risks when it extended its protection to euro zone banks. The ECB has also been clear in its actions and guidance, providing transparency and generating confidence. It also has room to launch further stimulus measures to bolster the euro zone economy and financial markets as well as reduce the risk of deflation if necessary.

There are many reasons to look at Europe as an investment in the near future. One factor in this equation is that the shift from bonds to equities that we have seen in the US as bond yields have risen has not yet taken place in Europe. Obviously, we need a more sustained flow of positive news to further lift confidence, but that should come.

Japan – a forgotten giant

Major changes in Japan, the third largest economy in the world and the fourth largest trading nation, have global implications. Many investors have more or less ignored Japan for a long time, but today the situation is different.

Japan’s new prime minister, Shinzo Abe, has kindled hopes that after two lost decades, the country’s economy will break out of its deflation and recession trap. If he succeeds, investors who dare to put their money into Japanese equities will be richly rewarded.

Meanwhile, a great risk of new disappointments still exists. It will probably be challenging for Japanese listed companies to report the earnings that analysts are now anticipating, given the economic scenario that we expect. In the long term, aside from entrenched deflation, energy challenges (most nuclear reactors in Japan remain closed after Fukushima nuclear accident) and a gigantic government debt, Japan also faces an enormous demographic challenge in the form of a narrowing population pyramid. This means that in the future, fewer and fewer workers will be supporting more and more pensioners.

The only thing we dare to promise is that it will be exciting to follow developments in Japan and the Tokyo Stock Market during the coming year. Price movements are likely to be sizeable.

SEB

Expected risk and return in asset classes in the next 12 months

Our risk and return expectations are taken from the SEB House View. These expectations cover the next 12 months. For equities, the forecast refers to the global stock market. For fixed income, the forecast refers to a basket of ½ investment grade and ½ high yield corporate bonds. The hedge funds forecast refers to representative of the overall composition of the hedge fund universe (comprised of all eligible hedge fund strategies). The real estate forecast refers to the real estate investment trust (REIT) market, while the commodities forecast refers to a basket in which the energy, industrial metal, precious metal and agricultural categories are equally weighted. Private equity forecast refers to the 50 largest listed private equity companies which fulfill certain liquidity constraints. As for currencies, the forecast refers to the alpha-generating capacity of a foreign exchange (FX) trading manager.

Since the last issue of *Investment Outlook* (dated May 28, 2013), it is worth noting that the highly diverse commodities asset class has an expected return of zero, but that within this asset class there are opportunities for returns, for example industrial metals and energy.

Asset class	Expectations next 12 months		Reasoning
	Return	Risk	
Equities	**8,5%**	**17%**	Expectations of better news headlines that will boost risk appetite may benefit equities. Valuations compared to bonds remain attractive. Major differences between various regions and sectors; those that have lagged behind will recover. In the next upturn phase, we regard cyclical sectors (industrials, financials and information technology) and selected countries in Europe, Asia and emerging markets that have lagged behind as the most attractive for investments.
Fixed income	**4%**	**6%**	Bond yields have risen and will continue to climb gradually, though slowly. Investors should be on their guard if interest rates start to rise, since higher rates would result in falling bond market values. The focus should be on the maturities, choosing shorter ones in a climate of rising yields. Government bonds are less attractive. Risk/reward ratio keeps becoming less attractive also in investment grade corporate bonds. Best risk/reward ratio remains in high yield bonds. The low-yield environment, the improving economy and good access to liquidity have resulted in a very low bankruptcy rate among issuers, which favours high yield investments.
- Government bonds	2%	4,5%	
- Investment grade corporate bonds	1,7%	2,8%	
- High yield corporate bonds	4.9%	9,3%	
Hedge funds	**4%**	**4%**	Market neutral strategies are our first choice, although the market climate is generally better for hedge funds. The trend of returns has stabilized.
Real estate	**6%**	**13%**	The market has matured, but transparency remains low. Investors are tending to move further out on the risk scale, especially since the search for “safe havens” has pushed down returns in primary markets.
Private equity	**10,5%**	**25%**	Good growth and reasonable valuations will benefit this asset class, provided that risk appetite among investors increases. In case of high market volatility, private equity is often severely affected.
Commodities	**0%**	**20%**	Weak trend, since worries about future demand have hurt this asset class. Economic growth in China will be the key issue, but risk is high and expected return is very low. Major differences among commodity categories, however. Industrial metals and energy may provide upside surprises, but it still feels early to “jump in”.
Currencies	**3%**	**4%**	Emerging market currencies are being pushed down. Reversing this trend will require better export data from Asia. EUR and USD markets are moving in a channel, but overall FX market performance is controlled primarily by monetary policies (FED’s “tapering” debate led to a strengthening of “safe haven” currencies). Our forecast implies a delayed appreciation in the USD, with a EUR/USD exchange rate of 1,33 at year-end (that is, no major change from the current level). By year-end 2015, we expect the EUR/USD to have fallen to 1,20.

View on regions

Region	Outlook	Reasoning
North America	**Neutral**	• Federal Reserve starts talking about reducing economy stimulus – difficulties in implementing monetary policy exits are biggest risk • The prospects for higher growth appears to still improve, but company earnings are growing more slowly than in other regions of the world (valuations are starting to be high) which will limit potential • Driving forces will be the housing market, now in a clear upturn phase, sounder household finances that will benefit private consumption, an impending acceleration in manufacturing activity • Government negotiation on fiscal year budget and debt ceiling will bring tension to the markets in the beginning of Q4
Western Europe	**Positive**	• European recession is over • Several countries have strengthened their competitiveness, while current account balances and public finances have improved • The European Central Bank (ECB) and fiscal stimulus measures will provide positive support, and macro data should continue stabilizing
Emerging markets	**Positive**	• Stock markets of Emerging markets have underperformed the rest of the world • Growth goes from very high to "only" high • Despite slower growth so far this year, Asia’s emerging market economies remain the fastest-growing in the world • Emerging market currencies have been pressed down – depreciating currencies benefit export-dependent economies which have suffered from weak external demand
Japan	**Neutral**	• Japan’s economy is on growth – increased confidence among businesses and households • Government’s stimulus package has led to rising stock, weaker yen and public investment boost, but assurance is needed that stimulus programmes (“Abenomics”) are sustainable going forward
Nordic	**Positive**	• Higher global growth favors the export-oriented Nordic economies • The domestic markets are strengthening in Sweden, Denmark and Norway, but in Finland, the domestic market will remain weak because of high unemployment and tight fiscal policy

Source: SEB Investment Outlook, September 2013

Terminology explanation

Terminology used	Explanation
Abenomics	"Abenomics" is a set of policy measures (launched by Japan's Prime Minister Shinzo Abe) meant to resolve Japan's macroeconomic problems. It consists of monetary policy, fiscal policy, and economic growth strategies to encourage private investment.
Deflation	A general decline in prices of goods and services. Deflation can be caused by a reduction in the supply of money, also by a decrease in government or personal spending. The opposite of inflation, deflation has the side effect of increased unemployment since there is a lower level of demand in the economy, which can lead to an economic depression. Central banks attempt to stop severe deflation, along with severe inflation, in an attempt to keep the excessive drop in prices to a minimum.
Domestic demand	Total purchases of goods and services, regardless of origin, by country's consumers, businesses, and governments during a given period. Domestic demand equals gross domestic product minus net exports.
Federal Reserve's "tapering"	This is an expression of the US Federal Reserve Bank's (US Central Bank) decision to reduce the volume of bond purchases (quantitative easing). Quantitative easing is a central bank's monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.
Gross Domestic Product (GDP)	The monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.
Household (private) consumption	Private consumption is defined as the value of the consumption goods and services acquired and consumed by households.
Leading indicator	A measurable economic factor that changes before the economy starts to follow a particular pattern or trend. Leading indicators are used to predict changes in the economy, but are not always accurate. Few examples of leading indicators include stock market performance, manufacturing activity, inventory levels.
Organization for Economic Cooperation and Development (OECD)	A group of 34 member countries that discuss and develop economic and social policy. OECD countries are democratic countries that support free market economies.
SEB House View	Economic forecasts prepared by economists, strategists and analysts of SEB bank.
SEB Investment Outlook	A public release prepared by SEB economists, strategists and analysts. Investment Outlook gives readers an in-depth look at the investment climate and the prospects for seven asset classes. It also provides advice about current risks and opportunities in the art of investing. The report can be read in its entirety at www.sebgroup.com
Yield	The income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.